UNIVERSITY OF COLOMBO-SRI LANKA
FACULTY OF ARTS
Master of Financial Economics

MFE 04: International Finance and Financial Institutions

Final Examination 2018

Time: Three (03) Hours

Answer **FIVE (05)** questions only.

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1. Financial systems facilitate the real sector activities by mobilizing financial resources among different sectors of the economy and providing them with financial instruments of different types to execute payments and settlements and also to manage wealth.

   a. Distinguish between the monetary system and financial system with suitable examples and brief explanations. (5 marks)

   b. How does direct financing differ from indirect financing? Explain briefly with suitable examples. (5 marks)

   c. How do money market instruments differ from capital market instruments? Explain briefly with suitable examples. (5 marks)

   d. Why is the yield rate on government debt securities considered as the bench mark to compare among different financial assets? Explain briefly. (5 marks)

(Total 20 Marks)

2. The Balance of Payments (BOP) is the summary account of all accountable foreign exchange transactions a nation with an open economy has with the rest of the world.

   a. How do transactions under Current Account (CA) differ from transactions under Capital and Financial Account (CFA) of the BOP? Explain briefly. (5 marks)

   b. An overall surplus in the BOP indicates a situation where the volume foreign exchange inflows exceeds the volume of volume of foreign exchange outflows. However, why an overall surplus in the BOP is not always considered as an indicator of strong performance in the external sector of the economy? Explain briefly. (5 marks)

   c. What support do you find in the external sector performance in Sri Lankan economy to substantiate your answer to the question "b" above? Explain briefly. (5 marks)

   d. If Sri Lankan experience in the external sector performance is not satisfactory, what lessons can Sri Lanka learn from open economies such as Singapore and China? Explain briefly. (5 marks)

(Total 20 marks)

3. Nominal Exchange Rate (NER), the rate at which one national currency is exchanged with another national currency, facilitates transactions associated with external sector economic activities of different types. The NER is used to assess the impact of such activities under different dimensions.
   a. Distinguish between the Nominal Exchange Rate (NER) and Real Exchange Rate (RER) and explain why RER is considered as a better indicator than the NER to analyze the external sector transactions? Explain briefly. (5 marks)

   b. How does Nominal Effective Exchange Rate (NEER) differ from the NER? Which one is a better indicator of external sector performance and why? Explain briefly. (7 marks)

   c. Sri Lanka has experienced a trend where the NEER and REER have moved in opposite directions? Is it a normal situation of an economy with satisfactory performance in the external sector and why? Explain briefly. (8 marks)

(Total 20 Marks)

4. Inflation rates are about price dimension of goods and services. Interest rates are about price dimensions of financial services. Exchange rates are about price dimensions of national currencies. They represent three different price dimensions that the Central Bank is concerned about under its responsibility to maintain Price Stability.

   a. What relationships do you see among the above three rates of price dimensions in a free market environment? Explain briefly. (5 marks)

   b. Policy interest rate is one of the monetary policy tools that the Central Bank uses under its monetary management. What is the mechanism that any change in policy interest rates is transmitted to changes in market interest rates? Explain briefly. (7 marks)

   c. "A nation with relatively higher rates of inflation should expect depreciation of the external value of its domestic currency sooner or later" Do you agree with the statement above? Explain briefly. (8 marks)

   (Total 20 Marks)

5. The Term Structure of Interest Rates or the Yield Curve is about the relationship between the yield rates of financial instruments and their terms to maturity. The Yield Curve can take different shapes under different circumstances. Answer the following questions with suitable graphs wherever relevant.

   a. What are the main characteristics of the Yield Curve under normal circumstances? Explain briefly. (5 marks)

   b. What are the circumstances under which the Yield Curve could be inverted. Explain briefly. (5 marks)

c. Imagine a situation where the Central Bank has signaled that projections indicate easing inflationary pressure, while data indicate improvements in government fiscal operations. What impact do you expect these developments to have on the Yield Curve? Explain briefly (10 marks)

(Total 20 marks)

6. An Exchange Rate Regime is a period during which the Central Bank follows a particular mechanism, among many, for the determination of the Nominal Exchange Rate (NER).

   a. Distinguish between the Fixed Exchange Rate Regime and the Freely Floating Exchange Rate Regime by highlighting their important characteristics. (5 marks)

   b. Since the Managed Floating Exchange Rate mechanism is a blend of both Fixed and Freely Floating mechanisms, it is considered as superior to other two mechanisms. Do you agree with the statement above? Explain briefly. (5 marks)

   c. What kind of a phenomenon is referred to by the concept of Exchange Rate Overshooting"? Under what circumstances could an economy encounter a situation of Exchange Rate Overshooting? Explain briefly. (10 marks)

(Total 20 Marks)

7. Super Equilibrium is a situation where the equilibrium situations of three main areas in a small economy; Real Sector, Money Market and Domestic Foreign Exchange Market, coincide. Answer the following questions with suitable graphs wherever relevant.

   a. What are the conditions associated with the Super Equilibrium? Explain briefly. (5 marks)

   b. Choose an overall disequilibrium situation in the economy and explain briefly the nature of disequilibrium in each main area. (8 marks)

   c. Explain briefly the nature of adjustment path in the economy from a disequilibrium situation to a super equilibrium situation. (7 marks)

(Total 20 Marks)

8. Answer the following questions <u>with brief explanations</u>

   a. Distinguish between the DD curve and AA curve (2 marks)

   b. What is the relevance of the Marshal Lerner Condition on the impact of devaluation or depreciation of domestic currency on the trade balance for the construction of the DD curve? (4 marks)

   c. Which of the two curves under question "a" above (DD or AA) would be affected by changes in the determinants of demand for money other than the interest rate? (4 marks)

d. Give a brief introduction to the concept of Super Equilibrium and explain what individual sectors are at equilibrium when the economy reaches the state of super equilibrium. (5 marks)

e. What impact would increase in inflation have on the super equilibrium, if the nation is following a freely floating exchange rate regime? Explain briefly. (5 marks)

(Total 20 marks)

9. Financial crises that emerge from time to time either at national level, or regional level or global level, could develop into economic crises as well. They disrupt smooth economic progress and disturb achieving sustainable and balance growth to deliver long lasting benefits for all segments in the society.

   a. Distinguish between a financial crisis and economic crisis. (5 marks)

   b. What are the possible determinants of a financial crises? Explain briefly by referring to the experiences related to Asian Financial Crisis and Global Financial Crisis. (7 Marks)

   c. Has the Sri Lankan economy suffered from negative effects of the recent global financial crisis? Explain briefly with suitable examples. (8 marks)

(Total 20 marks)
